Chapter 4

Professional Ethics

■ Concept Checks

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1. The following is the six-step approach to resolving an ethical dilemma:
   1. Obtain the relevant facts.
   2. Identify the ethical issues from the facts.
   3. Determine who is affected by the outcome of the dilemma and how each person or group is affected.
   4. Identify the alternatives available to the person who must resolve the dilemma.
   5. Identify the likely consequence of each alternative.
   6. Decide the appropriate action.

   Step 1 involves obtaining the relevant facts. In this case, a colleague has proposed that each staff person submit a mileage reimbursement request, even when they shared a ride. Step 2 involves identifying the ethical issues from the facts. In this case, most would consider it unethical to request mileage when it has not been incurred, although some may argue that each staff person could have driven separately and requested mileage. Step 3 involves determining who is affected. In this case, the two staff members, the firm, and the client are affected. Steps 4 and 5 involve identifying the alternatives and consequences. If the mileage is requested, the staff person will receive extra compensation and the firm would overpay for travel expenses and they would then overbill their client for those expenses. However, if the firm learns of this action, it could issue punishment up to termination from the firm. Step 6 involves deciding the appropriate action. Most people would say the appropriate action is not to request mileage unless it has actually been incurred, considering both what is ethical and the possible consequences.

2. There is a special need for ethical behavior by professionals to maintain public confidence in the profession, and in the services provided by members of that profession. The ethical requirements for CPAs are similar to the ethical requirements of other professions. All professionals are expected to be competent, perform services with due professional care, and recognize their responsibility to clients. The major difference between other professional groups and CPAs is independence. Because CPAs have a responsibility to financial statement users, it is essential that auditors be independent in fact (also known as independence of mind) and appearance. Most other professionals, such as attorneys, are expected to be an advocate for their clients.

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1. The Principles of Professional Conduct describe characteristics required of a CPA. The principles indicate the profession's responsibilities to the public, clients, and professional colleagues. The principles are designed to guide members in the performance of their professional responsibilities and meet the basic requirements of ethical and professional conduct. The six principles are:

    1. Responsibilities
    2. The Public Interest
    3. Integrity
    4. Objectivity and Independence
    5. Due Care
    6. Scope and Nature of Services

2. The conceptual framework for the Rules of Conduct is designed to assist members in situations where the interpretations of the rules do not address a threat to compliance with the rules. Using the conceptual framework, the member identifies threats, evaluates the significance of the threat, and identifies and applies safeguards to eliminate the threat or reduce it to an acceptable level.

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1. Independence of mind exists when the auditor is actually able to maintain an unbiased attitude throughout the audit, whereas independence in appearance is dependent on others' interpretation or perception of this independence and hence their faith in the auditor.

    Activities which may not affect independence of mind, but which are likely to affect independence in appearance are: (Notice that the first two are violations of the AICPA *Code of Professional Conduct*.)

    1. Ownership of a financial interest in the audited client.
    2. Directorship or officer of an audit client.
    3. Performance of management advisory or bookkeeping or accounting services and audits for the same company.
    4. Dependence upon a client for a large percentage of audit fees.
    5. Engagement of the CPA and payment of audit fees by management.

2. All members of the audit committee are required to be independent. Several audit committee activities help maintain auditor independence. The audit committee is responsible for the appointment, compensation, and oversight of the work of the auditor. The audit committee must preapprove all audit and nonaudit services, and is responsible for oversight of the work of the auditor, including resolution of disagreements involving financial reporting between management and the auditor.

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1. Members in public practice should not disclose confidential client information without the consent of the client. The four exceptions to the confidentiality requirement are:

    1. Obligations related to technical standards
    2. Subpoena or summons or compliance with laws and regulations
    3. Participation in peer review
    4. Response to AICPA Ethics Division

2. A member is prohibited from performing a service for a contingent fee if the member of the member's firm performs:
    (a) an audit or review of a financial statement; or
    (b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or
    (c) an examination of prospective financial information.

    The prohibition is necessary to help maintain the objectivity of the CPA in performing audits and other attest services.

■ Review Questions

4-1 The six core ethical values described by the Josephson Institute are:

1. Trustworthiness	4. Fairness
2. Respect	5. Caring
3. Responsibility	6. Citizenship

There are many other potential sources of ethical values, including laws and regulations, church doctrines, codes of professional ethics, and individual organizations' codes of conduct.

4-2 An ethical dilemma is a situation that a person faces in which a decision must be made about the appropriate behavior. There are many possible ethical dilemmas that one can face, such as finding a wallet containing money or dealing with a supervisor who asks you to work hours without recording them.

An ethical dilemma can be resolved using the six-step approach outlined on p. 81 of the text. The six steps are:

4-2 (continued)

1. Obtain the relevant facts.
2. Identify the ethical issues from the facts.
3. Determine who is affected by the outcome of the dilemma and how each person or group is affected.
4. Identify the alternatives available to the person who must resolve the dilemma.
5. Identify the likely consequence of each alternative.
6. Decide the appropriate action.

4-3 There is a special need for ethical behavior by professionals to maintain public confidence in the profession, and in the services provided by members of that profession. In addition to the *Code of Professional Conduct*, Figure 4-2 (p. 84) indicates additional factors that encourage CPAs to conduct themselves at a high level, including factors such as quality control standards, peer review, and legal liability.

4-4 The three categories of members under the Code of Professional Conduct are 1) members in public practice; 2) members in business; and 3) other members.

4-5 At the international level, the International Ethics Standards Board for Accountants (IESBA) establishes ethical standards and guidance and fosters international debate on ethical issues faced by accountants through its *Code of Ethics for Professional Accountants.* This international ethics code contains five fundamental principles related to integrity, objectivity, professional competence and due care, confidentiality, and professional behavior.

4-6 Independence in auditing means taking an unbiased viewpoint. Users of financial statements would be unlikely to rely on the statements if they believed auditors were biased in issuing audit opinions.

4-7 The rules concerning stock ownership by partners and professional staff:

A partner in the office of the partner responsible for an audit engagement cannot own stock in that audit client. A partner can own stock in an audit client, as long as (1) he or she cannot influence the audit engagement and (2) he or she is not in the same office as the partner responsible for the audit engagement.

A professional staff member cannot own stock in an audit client if he or she is assigned to the engagement or if he or she becomes a partner in the office of the partner responsible for the audit engagement. A professional staff member can own stock in a firm's audit client as long as he or she does not participate in the audit engagement.

4-7 (continued)

Partner violation: A partner in the San Francisco office owns one share of stock of a client whose audit is conducted by a different partner in the San Francisco office.

Professional staff violation: An audit manager owns stock in a client whose audit is performed by the office where the audit manager works. The manager is promoted to partner mid-year. As soon as the manager becomes a partner, there is a violation of independence.

4-8 Auditors of public companies are prohibited from performing the following nonaudit services:

1. Bookkeeping and other accounting services
2. Financial information systems design and implementation
3. Appraisal or valuation services
4. Actuarial services
5. Internal audit outsourcing
6. Management or human resource functions
7. Broker or dealer or investment adviser, or investment banker services
8. Legal and expert services unrelated to the audit
9. Any other service that the PCAOB determines by regulation is impermissible

Nonaudit services that are not prohibited by the Sarbanes–Oxley Act and the SEC rules must be preapproved by the company's audit committee. In addition, an accountant is not independent of an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services.

Companies are required to disclose in their proxy statement or annual filings with the SEC the total amount of audit and nonaudit fees paid to the audit firm for the two most recent years. Four categories of fees are to be reported: (1) audit fees; (2) audit-related fees; (3) tax fees; and (4) all other fees. Companies are also required to provide further breakdown of the "other fees" category, and provide qualitative information on the nature of the services provided.

4-9 Ways to reduce the appearance of the lack of independence are: the use of an audit committee to select auditors made up of directors who are not a part of management; a requirement that all changes of auditors and reasons therefore be reported to the SEC or other regulatory agency; and approval of the CPA firm by stockholders at the annual meeting. The Sarbanes–Oxley Act requires that the audit committee of a public company consist only of independent members and be responsible for the appointment, termination, and compensation of the audit firm.

4-10 A CPA firm has several options when it decides it is not competent to perform an audit:

1. Withdraw from the engagement.
2. Obtain the expertise through continuing education and self-studies.
3. Hire someone who has the expertise.
4. Work on a consulting basis with another CPA firm.

4-11 A fee based upon the amount of time it takes to complete is *not* a violation of the contingent fees rule, which states that professional services for clients receiving assertion opinions shall not be offered or rendered under an agreement whereby no fee will be charged unless a specific finding or result is attained, or where the fee is otherwise contingent upon the findings or results of such services. The purpose of the rule is to prevent sacrificing the quality of audits because of the pressure felt by the auditor in producing the required audit outcome. An example would be the fee being dependent upon the issuance of an unmodified opinion or the obtaining of a loan by a client.

4-12 Audits should be maintained at a high level of quality even if solicitation, advertising, and competitive bidding are allowed for several reasons:

1. Professionals do high quality work because it is a characteristic of being a professional.
2. A reputation of doing high quality work usually pays off in more clients and a more profitable practice.
3. Potential legal liability is also a deterrent to substandard work.
4. The *Code of Professional Conduct* requires a high quality of performance.

4-13 Acts that would be considered discreditable to the profession include conviction of a crime punishable by imprisonment for more than one year, the willful failure to file any income tax return that the CPA is required to file by law, or the filing (or aiding in filing) of a false or fraudulent tax return on behalf of the CPA or a client. In addition, it is considered discreditable to retain a client's records after a demand is made for them, to violate any antidiscrimination laws, or to solicit or disclose questions or answers of the Uniform CPA examination without permission of the AICPA.

4-14 Prohibiting paying commissions to obtain clients who receive attestation services is intended to discourage overly aggressive obtaining of clients by giving "finders' fees" to banks and others in a position to give business rather than on the basis of competitive and other qualifications. Prohibiting receiving commissions for referrals to other CPAs or other providers of services where attestation services are provided is intended to discourage referrals to others on the basis of a "sales commission" rather than the competition of those offering services. Commissions when attestation services are *not* provided are permitted to encourage competition for these types of services.

4-15 A CPA may practice in one of the following forms:

1. A proprietorship
2. A general partnership
3. A general corporation (if permitted by state law)
4. A professional corporation
5. Limited liability company (if permitted by state law)
6. Limited liability partnership (if permitted by state law)

4-16 Violations of the AICPA *Code of Professional Conduc*t may result in a remedial or corrective disciplinary action, such as requiring additional continuing education. More serious violations may require appearance before the Joint Trial Board, and may result in suspension of membership or expulsion from membership in the AICPA.

■ Multiple Choice Questions From CPA Examinations

4-17 a. (1) b. (3) c. (3)

4-18 a. (1) b. (1) c. (3)

■ Multiple Choice Questions From Becker CPA Review

4-19 a. (3) b. (3) c. (2)

■ Discussion Questions And Problems

4-20 a. Ethics are a set of moral principles or values. There are several challenges to developing a set of rules and guidance to increase ethical behavior in society. Each individual has their own set of values, and different groups define ethical values in different ways. Also, many ethical values cannot be defined well enough to be enforced.

b. Ethics is important to the conduct of business because it is difficult to transact with others without confidence that they will conduct business in an ethical manner.

c. There are several reasons people act unethically, including greed, selfishness, or the individual has different values than society.

d. Common rationalizations for unethical behavior include the argument that others are doing the same thing, that the behavior is not explicitly illegal, and the belief that the unethical behavior will not be detected.

e. Some believe that ethics are innate and cannot be taught. Others believe ethics should not be taught but instilled by parents and others. Among those who believe ethics should be taught, some believe there should be specific courses in ethics, and others believe ethics should be embedded throughout coursework.

4-21

	Service	Violation?
a.	Providing bookkeeping services to a public company. The services were preapproved by the audit committee of the company.	Yes
b.	Providing internal audit services to a public company client with the preapproval of the audit committee.	Yes
c.	Providing advice to a private company client on accounting for a merger with another private company	No
d.	Providing bookkeeping services to a private company. The source documents were prepared and authorized by the client.	No
e.	Providing internal audit services to a public company that is not an audit client.	No
f.	Implementing a financial information system designed by management for a private company.	No
g.	Recommending a tax shelter to a client that is publicly held. The services were pre-approved by the audit committee.	No *

* Recommending tax shelters is not prohibited as long as the service does not meet the characteristics of an abusive tax avoidance strategy and does not have the potential to impair independence.

4-22 a. Independence Rule – no violation, assuming Emrich has evaluated the threats and client management assumes appropriate responsibility for the services, including providing strategic direction for the advisory services and preparing source documents for the bookkeeping services.

b. Independence and Integrity and Objectivity – violation. Appearance of independence has been impaired by Steve Custer's agency's financial dealing with his audit clients and participation in a business, which impairs his objectivity. It is also a conflict of duties to recommend his own firm to review the adequacy of the existing insurance coverage of existing clients.

c. Confidential Client Information – violation. The client should have been notified that the review was to take place, and an attempt made to obtain the client's permission for such review since the review was not a part of an AICPA, state CPA society, or Board of Accountancy review program. The firms violated the rule on confidential client information by not obtaining consent from the client for the review.

4-22 (continued)

d. Independence – no violation. Franz Marteens is not a partner nor is he assigned to the engagement team for the audit client.

e. General Standards rule – violation. A member who accepts a professional engagement implies that he or she has the necessary competence to complete the engagement according to professional standards. Wilkenson has violated the rule since he does not have the expertise to review the work of the consultant hired by Wilkenson. Wilkenson should have suggested that the company hire the consultant directly.

f. Integrity and Objectivity – violation. This rule states that in tax practice, a member may resolve doubt in favor of his or her client as long as there is reasonable support for his or her position. In the example case, the client has provided no support for the unusual deductions. Sarah Milsaps has violated the rule on integrity and objectivity by not requiring reasonable support for the deductions.

g. Accounting Principles – violation. This rule designates that the International Accounting Standards Board (IASB) is the established body for issuing international financial accounting standards. Roberta Hernandez's assertion that the financial statements are based on international financial accounting standards would be in violation of the accounting principles rule because she did not use standards issued by the IASB.

h. Acts Discreditable – no violation. The rule is vague and the interpretation would be made by the state Board of Accountancy. In most states this will be a civil action and would not likely be a violation.

4-23 a. No violation of Independence Rule – When audit firms create a network with other firms to share certain characteristics, such as the sharing of audit methodologies and audit manuals, the *Code* requires each network firm to be independent of audit and review clients of other network firms. The ownership by Miller and Yancy, who are partners in one of the network firms, in the stock of a client of another network firm would not impair independence as long as Miller and Yancy have not involvement with the audit engagement.

b. Violation of Independence Rule – Only pre-existing mortgages provided by a new audit client that is a bank are permissible. No new mortgage loans are permitted, however.

c. No violation of Independence Rule– While Jennifer Crowe's audit client has a material investment in Polex, her non-dependent parents' investment in Polex represents an indirect financial interest that is not material to her parents or Jennifer. d. No violation of Independence Rule – Because Stokely has no responsibilities for financial reporting in his new role and because the audit firm modified audit procedures to reduce the risk that Stokely has knowledge of the audit plan, independence would not be impaired.

4-23 (continued)

e. Violation of Independence Rule – Independence is impaired if billed or unbilled fees remain unpaid for professional services provided more than one year before the date of the auditor's report. Since the fee for 2014 is unpaid, it is likely the audit firm was not independent for the 2015 audit. The firm would almost certainly not be independent for the upcoming 2016 audit. Because the report date for the 2016 financial statement audit would likely be in 2017, more than one year would have transpired.

f. No violation of Independence Rule – Because Jessica promptly notified her office's managing partner of the offer and because she was removed from the audit engagement, no violation has occurred.

g. Violation of Independence Rule – Providing financial information systems design and implementation services to a publicly traded client is prohibited under SEC independence rules and therefore would be considered a violation of the Independence Rule.

h. Violation of Integrity and Objective Rule and General Standards Rule – Both rules would be violated by Audrey's actions whereby she knowingly included false and misleading transactions in the financial statements that were provided to the bank.

i No violation of rule on fees – The prohibition of contingent fees does not extend to consulting services engagements as long as the CPA does not perform any other services for that client that might include audit, review, compilation, examinations of prospective financial information, or certain tax return services.

4-24 The *Code of Professional Conduct* and interpretations are not clear as to what constitutes a violation in these three situations. A central point is that Marie Janes must maintain independence of mind and in appearance because she is not an employee of the company and must not give the impression that she is one. The table on the following page applies the three-step process to evaluate whether independence is impaired.

4-24 (continued)

(a) POTENTIAL THREATS TO INDEPENDENCE	(b) POSSIBLE SAFEGUARDS?	(c) RULES OF CONDUCT VIOLATED?	(d) APPROPRIATE ACTION?
1. The ability to purchase a car at a substantial discount due to Marie's long-standing audit service may cause Marie to be favorably disposed to the client when evaluating the client's financial statements. Also, if users of the financial statements heard of this arrangement, some might perceive that there is a lack of independence.	1. Marie Janes' firm could establish policies regarding services provided by attest clients that require the managing partner's approval prior to engaging in any transactions with the client. Some transactions could be explicitly prohibited by the policy, while others may require the managing partner's approval.	1. Marie Janes has likely not violated the rules; the discount is available to customers on a widespread basis. Presumably many of the employees of the CPA firm buy automobiles from the dealership.	1. Marie Janes should discuss the discount with the firm's managing partner if she intends or wants to buy the automobile. She should certainly not feel compelled to buy the automobile, but she should not automatically turn it down. The situation would be entirely different if the sale were limited to employees. In such a case it would likely be a violation.
2. The ability to eat meals on an ongoing basis may cause Marie to be favorably disposed to the client when evaluating the client's financial statements. Also, if users of the financial statements heard of this arrangement, some might perceive that there is a lack of independence.	2. Marie Janes' firm could establish a policy regarding free services or gifts provided by clients. Perhaps the firm policy could establish a minimal dollar threshold of allowable free services or gifts. Those exceeding the threshold may either be prohibited by the policy or may require approvals by a more senior member of management of the audit firm.	2. If Marie Janes were to eat there on an ongoing basis, that would likely be a violation of the rules of conduct. It would not likely be a violation if she occasionally eats with employees who she is dealing with at the audit.	2. Marie Janes should eat elsewhere if it is practical to do so, but if the only practical place for her to eat is the lunchroom, she should make arrangements with her firm to make certain that the company is reimbursed for the expenses.
3. Gifts from clients might be perceived as a subtle form of bribe, and thus may create a lack of appearance of independence. Gifts may also cause Marie to be favorably disposed to the client when evaluating the client's financial statements. Also, if users of the financial statements heard of this arrangement, some might perceive that there is a lack of independence.	3. Marie Janes' firm could establish a policy regarding free services or gifts provided by clients. Perhaps the firm policy could establish a minimal dollar threshold of allowable free services or gifts. Those exceeding the threshold may either be prohibited by the policy or may require approvals by a more senior member of management of the audit firm.	3. Accepting such a gift is likely to be a violation of the rules of conduct. That gift is reasonably large, and would be considered by many employees as equivalent to a bonus.	3. Ideally Janes should not accept the gift and state that since she is not an employee, she would prefer not to take it. If she believes that it would be embarrassing to the company, she should graciously accept it and return it with an explanation of her reasons as soon as practical.

4-25 a. An audit committee is a special committee formed by the board of directors and made up of board members. The Sarbanes–Oxley Act requires that all the members of the audit committee be independent directors, and the committee should include at least one member who is a financial expert. The audit committee serves as a liaison between the independent auditor and the board of directors. The audit committee assists and advises the full board of directors, and, as such, aids the board in fulfilling its responsibility for public financial reporting.

b. An audit committee member is considered independent if they are not affiliated with the company or any subsidiaries in a capacity other than their capacity as a member of the board. For example, they cannot be an executive officer of the company. In addition, audit committee members, in order to be independent, are barred from accepting any consulting, advisory, or other compensatory fee from the company or its subsidiaries, other than in their capacity as a board member.

c. The functions of an audit committee may include the following:

1. Select the independent auditor; discuss audit fee with the auditor; review auditor's engagement letter.
2. Review the independent auditor's overall audit plan (scope, purpose, and general audit procedures).
3. Review the annual financial statements before submission to the full board of directors for approval.
4. Review the results of the audit including experiences, restrictions, cooperation received, findings, and recommendations. Consider matters that the auditor believes should be brought to the attention of the directors or shareholders.
5. Review the independent auditor's evaluation of the company's internal controls.
6. Review the company's accounting, financial, and operating controls.
7. Review the reports of internal audit staff.
8. Review interim financial reports to shareholders before they are approved by the board of directors.
9. Review company policies concerning political contributions, conflicts of interest, and compliance with federal, state, and local laws and regulations, and investigate compliance with those policies.
10. Review financial statements that are part of prospectuses or offering circulars; review reports before they are submitted to regulatory agencies.
11. Review independent auditor's observations of financial and accounting personnel.

4-25 (continued)

12. Participate in the selection and establishment of accounting policies; review the accounting for specific items or transactions as well as alternative treatments and their effects.
13. Review the impact of new or proposed pronouncements by the accounting profession or regulatory bodies.
14. Review the company's insurance program.
15. Review and discuss the independent auditor's management letter.

d. Management is frequently under considerable pressure from stockholders and the board of directors to maintain high earnings for the company. In some cases this may in turn motivate management to put pressure on auditors to permit a violation of accounting principles and therefore affect the reported earnings and disclosures in the financial statements. The board of directors has a greater responsibility to the stockholders for fairness in reported earnings. Directors, especially those who are outside directors, have less responsibility for high reported earnings.

Directors are therefore less likely to put pressure on auditors to deviate from high professional standards, and the audit committee can deal with the auditor in a less biased manner than can management. In addition, the board of directors has a legal responsibility to review the policies and actions of management. Therefore, there is considerable incentive for them to work closely with the auditor. A small committee of outside directors from the audit committee is therefore equipped to help the auditor to maintain a more independent relationship with the client. If management exerts any pressure on the auditor, the auditor is likely to discuss that with the audit committee and thereby resolve the problem.

e. For public companies, the PCAOB’s rules require a CPA firm, before its selection as the company’s auditor, to describe in writing and discuss with the audit committee all relationships between the firm and the company, including executives in financial reporting positions, to determine whether there is any impairment of the CPA firm’s independence. If the CPA firm is selected, these communications must occur annually.

f. The criticism of audit committees has been made by many smaller CPA firms. There may be some validity to the comment. At the same time, audit committees do have a responsibility to help a company control costs. Therefore if the cost of a smaller audit firm is significantly less than a large firm, assuming equal quality, the audit committee would be obligated to use the less expensive firm.

4-26 a. Independence is essential for an auditor because users of financial statements expect an unbiased viewpoint in the CPA's attestation to the fairness of the financial statements. If users believe that auditors are not independent, the value of the audit function is eliminated.

4-26 (continued)

b. Most other professions (attorneys, doctors, dentists, etc.) represent their clients and perform services intended primarily to assist their clients. For this reason no assumption of independence is required. The importance of independence for CPAs is similar to that for judges. For both, a nonadvocacy position is essential.

c. Independence in appearance is how independent the auditor appears to outsiders such as users of financial statements. Independence of mind refers to whether the auditor has maintained an attitude of independence throughout the engagement. For example, an auditor could possibly maintain an attitude of independence of mind (also described as independence in fact) even though he or she held shares of stock in a company and performed the audit (the auditor would have violated independence rules on stock ownership). However, the auditor would not likely be independent in appearance in such a situation. Both independence in appearance and of mind are essential and the AICPA *Code of Professional Conduct* concerns both.

d.
1. He has violated the *Code of Professional Conduct*. Independence rules prohibit any direct ownership by a partner or shareholder in the office that serves the client or for any partner or shareholder that serves on the engagement.
2. Such a small ownership is unlikely to have any impact on a partner's objectivity in evaluating the financial statements. It is unlikely to affect the partner's independence of mind.
3. Such ownership could affect the appearance of independence and therefore impact the reputation and credibility of auditors. Additionally, these strict requirements eliminate any controversy as to the line between material and immaterial ownership. It also shows outsiders the importance of independence to auditors and therefore hopefully improves the reputation of the profession.

e.

INDEPENDENCE OF MIND	INDEPENDENCE IN APPEARANCE	SOCIAL CONSEQUENCES OF PROHIBITING
1. May cause the auditor to permit misstatements to enhance personal wealth.	Users may perceive that auditors would permit misstatements to enhance personal wealth.	Minor, if any.

4-26 (continued)

INDEPENDENCE OF MIND	INDEPENDENCE IN APPEARANCE	SOCIAL CONSEQUENCES OF PROHIBITING
2. Person doing this audit may not do the audit work carefully because he or she did the bookkeeping.	Users may perceive that the auditor may not independently audit his or her own work.	Some clients find it less expensive to have bookkeeping services performed by an outside service. It is often less expensive to have this done by the auditor, because the auditor will already be knowledgeable about the business.
3. Person doing this audit may not do the audit work carefully because he or she would not question their spouse. The auditor also would not want to point out any errors due to a concern that their spouse may lose their job.	Users may perceive that the auditor may not independently audit the work of their spouse.	Minor, if any, as this should be relatively infrequent and the individual engagement team member could be replaced by another member of the firm.
4. The CPA firm may become complacent due to familiarity and not carefully evaluate potential misstatements.	Users may perceive the possibility of complacency.	Knowledge gained by an audit firm about a client's business is essential to evaluate when mis-statements in the financial statements are likely and to plan the audit. It is costly for a new audit firm to obtain that knowledge because of confidentiality requirements and communication difficulties between CPA firms.
5. The auditor may be unwilling to disagree with management for fear of being terminated.	Users may perceive that the auditor is unwilling to disagree with management.	Someone has to select the auditor. Management is usually in the best position to evaluate the effectiveness and cost of alternative auditors, especially for private companies.

4-26 (continued)

INDEPENDENCE OF MIND	INDEPENDENCE IN APPEARANCE	SOCIAL CONSEQUENCES OF PROHIBITING
6. There may be an absence of a careful independent check of the entries or preparation of the statements because they were originally prepared by the auditor.	Users may believe that the auditor may not independently audit his or her own work or that of a staff person from his or her firm.	Many clients lack technical expertise in accounting. Having services performed by the auditor is sometimes the least costly alternative.
7. The auditor may be reluctant to criticize or may not rely on a valuation estimate that was originally prepared by another department of the audit firm.	Users may perceive that the auditor is auditing their own work and will be reluctant to criticize or question the estimates.	A CPA firm gains considerable knowledge about a client and its business during the audit. Due to this knowledge, valuation services can often be provided by the same CPA firm at a lower cost than alternative sources such as other CPA firms or valuation consultants.

f. The AICPA *Code of Professional Conduct* and the SEC prohibit e(1) and e(3) if the person owning the stock or having a spouse employed as the CFO is a member of the engagement team or is a partner in the office of the partner primarily responsible for the audit engagement. The SEC also prohibits e(2), and e(6) would also be considered a violation if the adjusting entries were so extensive that they are, in essence, bookkeeping services. The SEC also prohibits the valuation services in e(7) if they are one of the nine nonaudit services prohibited by the SEC. Because the Sarbanes–Oxley Act requires that the audit committee select the auditor, e(5) is now also a violation of SEC rules.

4-27 a. The member should apply the conceptual framework when there is a threat to the member's compliance with the rules that is not addressed by an existing interpretation. The Independence Rule has its own conceptual framework.

b. Guidance on unsolicited financial interests is provided in section 1.240.020. The covered member should dispose of the gift as soon as practicable, and no later than 30 days after the member has the right to dispose of the gift. During the period after the member becomes aware of the gift but does not have the right to dispose of it, the threat is at an acceptable level if the member does not participate in the attest engagement team, and the financial interest is not material to the covered member.

4-27 (continued)

c. Section 1.320.030.03 indicates that new legislation or evolution of a new form of business transaction are examples of unusual circumstances that may justify a departure from the Accounting Principles Rule. An unusual degree of materiality and conflicting industry practices are examples provided that do not justify departure from GAAP. Depending on the severity of the violation, failure to follow the rules of conduct can result in expulsion from the AICPA, an investigation by the AICPA Professional Ethics Division, a requirement to remediate the problem (e.g., complete continuing education), or other sanctions. State Boards of Accountancy have the authority to revoke a CPA license. The PCAOB also has authority to sanction auditors and audit firms for violations of PCAOB regulations.

d. Section 1.600.030 describes how to refer to an AICPA-awarded specialty designation. A member may use the designation after their name. A member can include the designation on letterhead and marketing materials only if all of the firm's partners hold the designation.

■ Cases

4-28 The answers to these questions are more judgmental than most others in the chapter. They may, in some cases, be a violation of the spirit of the *Code* if the CPA is acting in a certain manner, and they may not be a violation if the CPA is acting in a different manner. Changing the facts throughout the discussion may increase the value of the case.

1. Elbert's wife's employment would not result in an independence violation since she is not in a financial reporting role, and also since Elbert is a staff accountant and is not on the audit engagement. Similarly, the stock ownership by Elbert's wife would not result in an independence violation since Elbert is a staff accountant and is not on the audit engagement. Individual audit firms, however, may have more restrictive rules that do not allow stock ownership in any audit clients.
2. Advertising is permitted as long as it is not false, misleading, or deceptive. The advertising expressly states two facts: 14 of 36 of the largest community banks are audited by their firm and second, the average audit fee, as a percentage of total assets, is lower than any of the other CPA firms in the city. Contel must be able to support those factual statements. Assuming he can, there is no violation. However, it may be difficult to support the comparison to the fees of other firms.

4-28 (continued)

3. Contingent fee arrangements between the CPA and the client are a violation of the rules for clients receiving attestation services. However, the rule on contingent fees specifically states that fees are not regarded as being contingent if fixed by courts or other public authorities or, *in tax matters, if determined based on the results of judicial proceedings or the findings of government agencies.* This situation involves tax matters, the results of which are determined by the IRS, which is a government agency, therefore there is no violation.
4. This would be considered a violation of the Independence Rule as Jon Davis is providing consulting services to his former audit firm. An audit firm's independence is considered to be impaired with respect to a client when a former partner who is now employed by the audit client in a key position has an association or appearance of association with the audit firm.
5. According to an interpretation of the Independence Rule, independence would be considered to be impaired if Able and the client or an officer of the client have a joint closely held investment that is material to Able. This is difficult because it is possible that Able and Marshall are unaware of this joint closely held investment since in many cases the limited partners do not know of the other investors in the limited partnership.
6. It is essential that Finigan retain both an attitude of independence in mind and in appearance. It is not possible to determine if Finigan is maintaining an attitude of independence in fact, given her involvement in the company, but it is certainly possible that she is. Finigan is not necessarily violating the *Code of Professional Conduct*. She does the audit, tax return, bookkeeping and management services work for the client, but that is not a violation if Gilligan is a private company.

   It is questionable whether Finigan is maintaining an attitude of independence in appearance, especially given the comments by Gilligan. It is essential that she maintain an attitude of independence throughout all her work. So she must be careful that she is not on the side of Gilligan without consideration of her professional responsibilities in conducting the audits and in all other aspects of her professional responsibilities.

4-29 a. It's an ethical dilemma for Barbara because she has a decision to make about what behavior is appropriate. If she throws the schedules away, as suggested by her supervisor, she may not be carrying out her professional responsibility to the public or the client. If she does not throw the schedules away, she will likely cause a confrontation between herself and her supervisor.

b. 1. Relevant facts: A number of misstatements were discovered. The aggregate amount of all discovered and undiscovered misstatements may be material. The audit supervisor wants Barbara to throw away some of her work.

2. Ethical issues: Is it ethical to throw away the schedules containing some small misstatements when her supervisor instructs her to do so?

3. Who is affected and how?

WHO IS AFFECTED?	HOW?
Barbara	1. Being asked to ignore misstatements is a possible violation of the Integrity and Objectivity Rule. 2. Performance evaluation may be affected. 3. Future with firm may be affected.
Jack	1. Future with firm may be affected. 2. Performance evaluation may be affected.
Green, Thresher & Co., CPAs	1. If audit is completed late, they may lose the engagement. 2. May be sued if material misstatements are not detected. 3. Client may be unhappy with auditor if misstatements are subsequently discovered.
Delancey Fabrics	1. May not have opportunity to correct misstatements if they are not brought to light. 2. May be required to adjust financial statements if misstatements exist.

4. Alternatives
   (a) Throw away schedules.
   (b) Inform Jack that she will not throw schedules away.
   (c) Talk to manager or partner about Jack's request.
   (d) Refuse to work on the engagement.
   (e) Quit the firm.

5. Consequences
   (a) The misstatements may be discovered subsequently and the firm may lose the client, or be sued. Even if the misstatements are not material, the client may be justifiably upset because the problems giving rise to the misstatements may have been solved sooner.

4-29 (continued)

(b) Barbara informs Jack that she won't throw away schedules. This may result in a confrontation. She may get an unfavorable review.

(c) If she talks to the manager or partner, they may admire Barbara's attempt to be ethical, or they may think she is out of line for bypassing Jack's authority without discussing the matter with him in detail.

(d) If she refuses to continue on the engagement, it will not look good on Barbara's record. She may be labeled as "hard to get along with."

(e) If she quits, she will likely miss out on some potentially valuable experiences in public accounting.

6. Appropriate Action

Only Barbara can decide. One reasonable approach is for Barbara to start by discussing the matter further with Jack. She should listen carefully to his reasoning and express her reservations about throwing the schedules away. She should not subordinate her judgment to Jack, as this would be a violation of the Integrity and Objectivity rule. If Jack satisfies her that it is acceptable to throw the schedules away (this seems unlikely in the circumstances), then she may be justified in doing so. However, if she still has reservations, she should inform Jack that she intends to contact a manager or partner.

4-30 1. Relevant Facts:

a. One of Ann Donnelly's audit engagements has been selected for a PCAOB inspection.

b. Ann has been asked by the engagement partner to add a backdated document to the working papers and ensure that all appropriate signatures are included in the working papers, which is a direct violation of PCAOB standards.

2. Ethical issue: Is it ethical for Ann to alter the working papers for the audit engagement?

3. Who is affected and how?

WHO IS AFFECTED?	HOW?
Ann	1. Promotion, future pay, and ability to meet personal financial obligations may be affected. 2. She may face penalties if a deficiency is identified in a PCAOB inspection. 3. She may face penalties if she alters the working papers and the violation is discovered.

4-30 (continued)

WHO IS AFFECTED?	HOW?
Partner	1. Promotion, future pay, and ability to meet personal financial obligations may be affected. 2. He may face penalties if a deficiency is identified in a PCAOB inspection. 3. He may face penalties if the working papers are altered and the violation is discovered.
The audit firm and the local office	1. The audit firm, particularly the local office, may suffer penalties due to a lack of proper controls and supervision, if it is discovered the working papers were altered in violation of PCAOB standards.
Other engagement personnel	b. The inspection process impacts all engagement personnel and they did not have any input in this decision. c. If the alteration of working papers is discovered, other engagement personnel will be questioned and possibly implicated in the PCAOB violation.

4. Alternatives:
    a. Alter the working papers as requested by the partner.
    b. Add a document to the working papers, but date it in accordance with PCAOB standards.
    c. Refuse to alter the working papers and accept the consequences that may come from the inspection process.
    d. Inform the managing partner of the office of the engagement partner's request.
5. Consequences:
    a. If Ann alters the working papers as requested by the partner, she has violated PCAOB standards and will likely suffer consequences.
    b. If she updates the working papers but ensures she is in compliance with PCAOB standards, an audit deficiency may be identified in the PCAOB inspection process. This may or may not have consequences for Ann depending on the audit firm's policy.
    c. With either choice a. or b., the partner, Ann, and the audit firm may suffer consequences of a PCAOB sanction or the identification of an audit deficiency.
    d. If Ann informs the office managing partner of the engagement partner's request, she may be labeled as someone who is not willing to cooperate. Other partners may not want to work with Ann in the future. If the engagement partner remains with the local office, Ann may not be considered for promotion to partner.

4-30 (continued)

6. Appropriate action:

   Ann should refuse to alter the working papers and be willing to accept any deficiencies identified by the PCAOB in the inspection process. The consequences of an identified audit deficiency are significantly less severe than if a violation of PCAOB standards is identified. In addition, Ann should disclose the engagement partner's request to the office managing partner. Most, if not all, of the other partners in the firm would probably appreciate Ann's willingness to express her opinion regarding the inappropriateness of the engagement partner's request.